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SUBJECT: INDONESIA RIDING OUT GLOBAL DOWNTURN WELL

¶1. (SBU) Summary: Indonesia is riding out the global downturn well. Second quarter GDP growth of 4.0 percent year-on-year came in above expectations and first half 2009 growth of 4.2 percent was among the highest in Asia. Improved global sentiment and higher commodity prices have benefited Indonesian financial markets, as have capital inflows attracted by political stability following peaceful elections and by high returns on rupiah assets. Although Indonesia remains vulnerable to shifts in global sentiment, the main stock index has risen by more than 76 percent and the rupiah has appreciated against the US dollar by over nine percent year-to-date. Bank Indonesia cut the policy interest rate by 25 basis points to 6.5 percent on August 5, after consumer price inflation fell to 2.71 percent in July, a nine-year low. The Indonesian government and corporate sector continue to successfully access capital markets. Trade also improved in June and officials here have projected higher growth in the second half as global demand recovers and fiscal stimulus expenditures kick in. End summary.

Second Quarter Growth of 4 Percent Exceeds Expectations
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¶2. (U) Indonesia registered stronger than expected GDP growth of 4.0 percent year-on-year (y-o-y), down slightly from first quarter growth of 4.4 percent, Statistics Indonesia reported August 10. On a quarterly basis, growth accelerated to 2.3 percent, up from a revised 1.7 percent pace in the first quarter. First half 2009 GDP growth of 4.2 percent (y-o-y) remained among the strongest in the region. The positive results have triggered some market analysts to upgrade growth forecasts for both 2009 and 2010.

¶3. (U) All major sectors of the economy grew in the second quarter, supported by strong government consumption and moderating household consumption. Government consumption increased by 17.0 percent y-o-y and 23.7 percent quarter-on-quarter (q-o-q). Household consumption rose by 4.8 percent y-o-y and 0.2 percent q-o-q. Gross fixed capital investment rose by a modest 2.7 percent y-o-y, 2.4 percent q-o-q. Exports increased by 7.4 percent q-o-q, but declined 15.7 percent y-o-y. Sectors driving growth in the second quarter included transportation and communications (up 17.5 percent y-o-y) and electricity, gas and water (up 15.4 percent y-o-y). Agricultural production rose by 2.4 percent y-o-y and manufacturing increased 1.5 percent y-o-y. Industrial production by large and medium firms also increased by 2.11 percent q-o-q, after a first quarter decline of 1.65 percent. Production of textiles, food and beverages and motor vehicles showed the strongest improvement for the period. Industrial production for the second quarter rose by 0.38 percent y-o-y.

BI Cuts Policy Rate Again, As Inflation Hits 9-Year Low

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¶4. (U) Bank Indonesia (BI) cut its overnight policy interest rate by 25 basis points to 6.5 percent August 5, in line with market expectations. This brought total monetary easing to 300 basis points since BI began cutting rates in December. In its monetary policy statement, the Board of Governors said inflation would continue falling on still limited domestic demand and declining inflation expectations, but noted the likelihood of rising inflationary pressure in 2010, fueled by growing domestic demand and increases in international commodity prices. The Board said monetary policy would be directed to anticipate this increased inflationary potential and to achieve the 2010 inflation target of about five percent. Many analysts expect the August cut will be BI's last in this easing cycle. BI said it expects 2009 growth to reach the upper limit of the 3.5 to 4.0 percent range. Foreign reserves slipped slightly to USD 57.4 billion as of end-July, equivalent to 5.5 months of imports and servicing of official external debt, from USD 57.58 billion at end-June).

¶5. (U) Tame consumer price inflation, helped by a strengthening rupiah, reached a nine-year low of 2.71 percent year-on-year in July, down from 3.65 percent in June. Consumer prices rose 0.45 percent month-on-month (from 0.11 percent in June). Prices increased across most product groups, including food, which climbed 1.1 percent m-o-m. Core inflation rose 0.31 percent m-o-m, and 4.91 percent y-o-y, down from 5.56 percent in June.

¶6. (U) BI reported that national banking conditions remained stable. The capital adequacy ratio stood at 17.0 percent in June, down from 17.3 percent in May, and gross non-performing loans fell to 4.5 percent (from 4.7 percent in May). Banks' interest rate response to

cuts in the BI rate has improved slightly, with deposit rates declining by an average of 188 basis points and lending rates falling by an average 24 basis points from December 2008 through June 2009. Bank lending expansion remains very slow on slack demand and caution by lenders about credit quality. Lending growth y-o-y slowed in June to 15 percent, from 17.7 percent in May.

June Trade Surplus Narrows As Imports Rebound
More Sharply Than Exports
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¶7. (U) Trade improved in June, but remained in the doldrums on an on-year basis, according to Statistics Indonesia. Imports rebounded more sharply (rising 4.1 percent m-o-m to USD 7.95 billion) than exports (up 1.3 percent m-o-m to US 9.33 billion), resulting in a smaller trade surplus of USD 1.4 billion in June, down from USD 1.6 billion a month earlier. June imports declined by more than 34 percent y-o-y, while exports declined by more than 27 percent y-o-y, not seasonally adjusted. Non-oil and gas imports rose by 7.1 percent to USD 6.5 billion, while oil and gas imports fell by 7.6 percent to USD 1.4 billion. Oil and gas exports rose by nearly 28 percent on higher crude oil prices and higher volumes (crude oil volume rose by 4.1 percent and natural gas by 12.6 percent). Non-oil and gas exports declined by 2.4 percent, led by a USD 473.8 million drop in animal/vegetable fats and oils and a USD 110 million drop in mineral fuels.

¶8. (U) Indonesia's non-oil and gas trade with China declined in June, with Indonesian exports slipping 0.8 percent to USD 727.7 million and imports down by 2.8 percent to USD 1.04 billion. Its trade with Japan rose significantly, with exports up 12.8 percent to USD 1.03 billion and imports up 17.4 percent to USD 836.5 million. Indonesia's trade with ASEAN also increased, with exports up 7.4 percent to USD 1.83 billion and imports up 11.9 percent to USD 1.46 billion. Indonesia's non-oil and gas exports to the U.S. rose by 3 percent to USD 876.4 million, while its imports from the U.S. fell by 15 percent to USD 519 million. Trade with the EU declined, with non-oil and gas exports falling 12.7 percent to USD 1.03 billion and imports falling by 9.2 percent to USD 737.9 million.

¶9. (U) Imports of consumer goods rose by 8.3 percent (to USD 547.4 million) and imports of raw materials and intermediates increased by

7.9 percent to USD 5.87 billion. Imports of capital goods fell by 9.5 percent to USD 1.53 billion, led by a sharp decline in aircraft imports.

Market Rally
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¶10. (U) Indonesian financial markets have rallied on extremely positive sentiment and increasing capital inflows -- which some, including BI, have termed euphoria. The July 17 Jakarta bombings had only a temporary and extremely limited impact on financial markets. In recent weeks, the Jakarta Composite Index has climbed to nearly 2,400 points, for a gain of over 76 percent through August 13, and the rupiah strengthened to below IDR 10,000/USD. High yields have drawn increasing foreign interest in BI certificates and government and corporate bonds. Yields on Indonesian government bonds declined from nearly 13.8 percent on ten-year bonds in early March, to about 10 percent in late July, before ticking up again (to about 10.5 percent on August 13) as prospects dim for further BI rate cuts.

¶11. (SBU) Meanwhile, the Indonesian government continues to successfully access capital markets. The Finance Ministry announced August 10 that the government had financed over 82 percent of the planned 2009 budget deficit. The government has further diversified its sources of financing, concluding a JBIC-backed yen-denominated Samurai bond in the amount of 35 billion yen on July 29 in a private placement. The ten-year bonds carried a 2.73 percent coupon and were sold at par. On August 10, the Finance Ministry announced that its sixth retail offering of rupiah bonds had drawn strong demand (IDR 8.5 trillion, about USD 860 million). The issuance of these three-year bonds, which carry a 9.35 percent annual coupon, closed on August 12. Indonesia and Japan's agreement in July to establish a yen swap arrangement in the amount of 1.5 trillion yen (USD 15.6 billion) as a precautionary measure has provided additional assurance to markets regarding Indonesia's ability to respond to a crisis and helped to reduce currency volatility.

¶12. (U) The Indonesian corporate sector has also taken advantage of

improved conditions to raise financing, completing what has been described as the first high-yield offerings in Asia since Lehman Bros. collapsed. During the first week of August, retailer PT Matahari Putra Prima raised USD 200 million in three-year bonds reportedly priced to yield 11.75 percent and state-owned power company PT PLN raised USD 750 million by issuing 10-year U.S. dollar-denominated bonds, priced to yield 8.125 percent. At the end of July, state-owned oil and gas firm Pertamina signed syndicated loans for USD 400 million and IDR 3 trillion (about USD 300 million) with local and foreign banks.

¶13. (SBU) Indonesia continues to make its case for credit ratings upgrades following Moody's change in outlook for Indonesia's Ba3 sovereign rating to positive from stable in June. On July 7, the Japan Credit Rating Agency upgraded its ratings on the foreign currency long-term senior debts of Indonesia to BB+ from BB and on its local currency long-term senior debts to BBB- from BB+, with stable outlooks on both.

Prospects and Challenges: Spending the Money
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¶14. (SBU) While Indonesia remains vulnerable to sudden shifts in risk aversion and capital flows given its open capital account, the government's economic policy team and BI continue to receive strong marks, including from the International Monetary Fund in its recent Article IV statement, for their effective handling of the rough economic climate. An immediate challenge for the Yudhoyono administration (current and incoming) will be to maintain growth in the second half of 2009 without the election-related spending which supported strong consumption in the first half of the year. Most market observers believe BI has reached the end of its current monetary easing and that fiscal stimulus will need to support growth going forward. The private sector is urging the government to speed up execution of the 2009 budget to spur demand. Continued strong

consumer confidence -- at its highest level in five years according to a July BI survey -- and lower lending rates are expected to support domestic demand in the third and fourth quarter of 2009.